SIA

Foreign Activity

An Analysis of Foreign Participation in the U.S. Securities Markets
Produced by the SIA Research Department

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Foreign Activity in U.S. Securities

"Highlights"

1. Anticipation of a rally in the U.S. stock market outweighed a depreciating dollar in the investment decision of foreign investors in the third quarter of 1985. Foreign net purchases of U.S. equities jumped to $1.4 billion from $529 million in the second quarter. We estimate that foreigners continued to be enthusiastic purchasers of U.S. equities in the fourth quarter, with net purchases surpassing the third-quarter level.

2. Foreign gross activity in U.S. equities in 1985 has consistently been above comparable 1984 levels. For the first three quarters of 1985, gross foreign activity at $108.7 billion is running 15% above the $94.6 billion registered for the same period in 1984.

3. Attractive returns spurred increased foreign attention to U.S. corporate bonds, including Euro-issues, in the third quarter. Foreign acquisition of U.S. corporate bonds rose 68% to $8.6 billion from $5.1 billion in the second quarter.

4. Japanese net purchases of U.S. Treasuries stepped up in the third quarter to an unprecedented $6.9 billion from $5.4 billion in the second quarter. However, large net sales of $2.4 billion by nonmonetary international organizations dampened quarterly purchases. Thus, foreign net purchases of Treasuries slid 36% in the third quarter to a still-substantial $8.3 billion from a record $13.1 billion in the second quarter.

5. Continued gains by most major foreign stock markets plus appreciating currencies vis-a-vis the dollar prompted U.S. investors to acquire $987 million of foreign stocks in the third quarter. At $3.1 billion for the first three quarters of 1985, U.S. purchases of foreign stocks stand a very good chance of surpassing the $3.8 billion record set in 1983.

Introduction

Anticipation of a rally in the U.S. stock market outweighed a depreciating dollar in the decisions of foreign investors in the third quarter. Foreign interest in U.S. equities was piqued in the second quarter as the market rose to record levels. A cautious course was evident, nevertheless, as second-quarter net purchases totaled a relatively modest $529 million, with 76% of this amount purchased in June. Given some staying power to the market rally early in the third quarter, foreign investors purchased over $600 million of U.S. equities in both July and August. Thus, foreign net purchases of U.S. equities jumped to $1.4 billion in the third quarter.

Although the stock market rally stalled at the end of the third quarter, preliminary data show that foreign investors were enthusiastic buyers of U.S. equities in the fourth quarter. Given the vigor of the market, particularly in December, we believe that foreign net purchases of U.S. equities in the fourth quarter surpassed the third-quarter level. Foreign investors were evidently not deterred by the Group of Five decision to place downward pressure on the dollar.

With the exception of the Canadian dollar, most major currencies made sharp strides upward against the dollar in the third quarter. Both the yen and the Swiss franc gained about 15% vis-a-vis the dollar, while the French franc and German mark appreciated around 13%. The dollar lost almost 8% to the pound. Assisted in part by official intervention, most major currencies continued to strengthen against the dollar in the fourth quarter, although gains were less than in the third quarter.

The U.S. stock market held on to its June record highs through July, then trended down modestly over the remainder of the third quarter. On a quarterly basis, the S&P 500 and the NYSE indices fell about 5%, while the DJI Average was off by less than 1%.

Foreign Activity in U.S. Equities

Gross Activity

Foreign investors sustained the same pace of gross transactions in U.S. equities in the third quarter as in the second, slightly over $35 billion. Regional transactional patterns were also little changed on a quarterly basis. While activity from the European and Latin American and Caribbean regions was cut back by 2% and 5%, respectively, Canadian investors boosted transactions by 7% to $5.3 billion. Transactions by Asian investors held steady at $5.4 billion in the third quarter.

Gross activity in 1985 has consistently been above comparable 1984 levels. For the first three quarters of 1985, foreign activity in U.S. equities at $108.7 billion was $14.1 billion, or 15%, above the $94.6 billion registered for the same period in 1984.

Net Purchases

In the third quarter, foreign purchases of U.S. equities increased to three times the second-quarter level. With investors from all major regions taking positive investment positions, third-quarter purchases jumped to $1.4 billion from $529 million. European investors swung from net sellers of $369 million in the second quarter to net purchasers of $869 million. Similarly, Canadian investors reversed their investment pattern, from net sellers of $20 million to net purchasers of $168 million. However, Asian and Latin American and Caribbean investors reduced purchases by 63% to $151 million and $204 million, respectively.

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1985 Second Quarter		1985 Third Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$18,061	$(369)	$17,689	$869
Belgium-Luxembourg	859	60	1,014	64
France	1,343	67	1,286	(164)
Germany	1,144	66	1,210	232
Netherlands	965	(117)	892	80
Switzerland	4,866	(91)	4,491	(77)
United Kingdom	8,286	(356)	8,250	691
Canada	4,971	(20)	5,341	168
Latin America & Caribbean	6,417	546	6,077	204
Bermuda	2,679	223	2,296	211
Netherlands Antilles	1,986	210	1,633	(82)
Asia	5,355	409	5,371	151
Hong Kong	661	79	763	83
Japan	1,355	191	1,502	(124)
"Other Asia"*	2,776	43	2,705	142
Total All Countries	$35,465	$529	$35,293	$1,427

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

The renewed foreign interest in U.S. equities in the second and third quarters of 1985 offset negative first quarter activity. Thus, for the first nine months of 1985, foreign activity resulted in net purchases of $772 million, compared with net sales of $1.5 billion for the same period in 1984.

European Investors

After making net sales of $1.7 billion of U.S. equities in the first half of 1985, European investors swung to net purchasers of $869 million in the third quarter. A dramatic reversal in investment posture by U.K. investors and increased German interest largely accounted for the turnabout. Investors located in the Netherlands also adopted a positive attitude toward U.S. equities, purchasing $80 million, and Swiss investors moderated their net selling to $77 million. French investors were the only major ones to take a negative posture toward investing in U.S. equities, swinging to net sellers of $164 million from net purchasers of $67 million in the second quarter.

The easing of U.K. interest rates and the subsiding of inflationary pressure, which spurted to 7% in the second quarter, prompted U.K. investors to reassess equity investments. The third quarter saw the start of a rebound for the U.K. stock market, after lackluster performance in the first half of the year, and the return of U.K. investors to the U.S. stock market. U.K. investors made net divestitures of almost $600 million of U.S. equities in the first half of 1985. In the third quarter, these investors swung to net purchasers of $691 million.

The German stock market suffered a mild setback in the middle of the third quarter, prompting a bit of speculation that one of the most robust market runups of the year was about to come to an end. Although the German market finished the quarter among the top five performing international markets, German investors sought increased diversification. Net purchases by German investors jumped to $232 million in the third quarter from $66 million in the second.

The continued strong performance of domestic markets held the attention of Swiss investors in the third quarter. Net sales of U.S. equities by these investors were $77 million, compared to $91 million during the second quarter. The Swiss stock market has benefited from low inflation, stable economic growth, and increased profitability of many Swiss corporations. Enhancing stock market progress has been renewed interest in the franc as a "hard" currency, coupled with increased demand from U.S. and British institutional investors.[1/]

1/ "Switzerland", Financial Times Survey, 12/13/85.

French investors swung to net sellers of $164 million of U.S. equities in the third quarter from net purchases of $67 million in the second. The French stock market paused in the summer months before continuing its uphill climb. Although interest rates dropped and the market enjoyed considerable liquidity, foreign institutions have adopted a wait-and-see approach and other buyers are characterized as indecisive.2/ Prospects of the upcoming March parliamentary elections have made market participants cautious. Nevertheless, French investors were not betting on a sustained rally in the U.S.

Canadian Investors

Canadian investors resumed their long-standing interest in investment in U.S. equities in the third quarter. After swinging to net sellers of $20 million in the second quarter, Canadian investors purchased $168 million of equities. The relatively strong performance of the Canadian economy in 1985 surprised many forecasters: real GNP of over 3%, inflation under 4%, and an easing of unemployment. While these economic fundamentals translated to certain sectors of the Canadian stock market in 1985, Canadian investors may have been seeking wider diversification in the U.S. markets

Latin American & Caribbean Investors

Net purchases of U.S. equities by Latin American and Caribbean investors dropped sharply to $204 million in the third quarter from $546 million in the second. While purchases by investors located in Bermuda were maintained at about the same level, $211 million, investors located in the Netherlands Antilles made a turnabout. These investors swung to net sellers of $82 million from net purchasers of $210 million in the second quarter. Bolstering the total net purchase figure, however, were purchases of $24 million and $34 million stemming from the British West Indies and Mexico, respectively (not shown in Table I).

Asian Investors

In the third quarter, net purchases by Asian investors fell by 63% to $151 million from $409 million in the second. The reversal by Japanese investors to net sellers of $124 million of U.S. equities from net buyers of $191 million in the second quarter was responsible for the decline. Second-quarter activity by these investors represented an atypical investment position, as Japanese investors traditionally favor fixed-income instruments. Thus, the adoption of a net divestiture position is not unusual. What is somewhat unusual, however, is the escalation of net purchases by the oil-exporting countries to $142 million. Large scale net

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2/ "World Stock Market Review," Institutional Investor, 11/85

divestitures were made by these countries in 1984, but a distinctly different approach has been taken in 1985. After making net sales of $47 million in the first quarter, the oil-exporting countries purchased $185 million of U.S. equities over the next two quarters.

Foreign Activity in U.S. Corporate Bonds

Attractive returns spurred increased foreign attention to U.S. corporate bonds, including Euro-issues, in the third quarter. Foreign acquisition of U.S. corporate bonds, including Euro-issues, jumped 68% to $8.6 billion from $5.1 billion in the second quarter. Although yields on U.S. corporate bonds followed an uneven path over the third quarter, monthly average yields were 25-40 basis points above the 11.25% recorded at the end of June.3/ In contrast, average returns on corporate bonds in other industrialized countries drifted down over the quarter.

TABLE II

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS
($ Millions)

	1985 Second Quarter		1985 Third Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$11,948	$5,208	$14,210	$8,165
Belgium-Luxembourg	382	217	197	11
Germany	1,801	156	1,814	500
Switzerland	854	217	1,522	936
United Kingdom	8,319	4,663	9,984	6,480
Asia	3,305	(192)	3,299	629
Japan	1,298	646	1,688	864
"Other Asia"	1,664	(951)	1,244	(337)
Total All Countries	$17,335	$5,125	$19,465	$8,596

Source: U.S. Treasury

3/ Based on international data in World Financial Markets, Morgan Guaranty Trust Company

European investors boosted net purchases of U.S. corporate bonds by 57% to $8.2 billion from $5.2 billion. U.K. investors escalated net purchases by 39% to $6.5 billion from $4.7 billion in the second quarter. The swing in the interest rate differential between U.S. and U.K. corporate bonds accounted for the increase in U.K. purchases. U.K. rates, which were above U.S. rates in the second quarter, fell 32 basis points from end-June to end-July and remained at the new level through the quarter. U.S. rates, on the other hand, spurted 40 basis points in July. Both Swiss and German investors dramatically increased net purchases, to $936 million and $500 million, respectively.

Asian investors purchased $629 million of U.S. corporate bonds in the third quarter, compared to net sales of $192 million in the second quarter. While the oil-exporting countries cut back net sales to $337 million from $951 million, Japanese investors increased net acquisitions by 34% to $864 million. Japanese investors' enthusiasm for U.S. fixed-income investment has expanded from the Treasury market to the corporate bond sector.

Foreign Activity in U.S. Treasuries

In late September, the Group of Five -- U.S., West Germany, Japan, Britain and France -- announced a coordinated program designed to force down the dollar's value against other major currencies. Given the timing of this announcement, any related effects could not be captured in the third-quarter data. Consequently, the 36% slide in third-quarter foreign net purchases of Treasuries to a still-substantial $8.3 billion from a record $13.1 billion reflects other factors. While acquisition activity was reduced by both European and Asian investors, large net sales of $2.4 billion by nonmonetary international organizations dampened the quarterly level. At the end of September, estimated foreign holdings of U.S. Treasuries stood at $132.0 billion, compared to $123.7 billion at the end of June.

Net purchases of Treasuries by European investors dropped 21% to $2.9 billion in the third quarter from $3.7 billion in the second. The interest rate differential favoring U.S. government issues over similar German issues widened in the third quarter providing German investors with continued enthusiasm for Treasuries. German investors upped their net purchases by 26% to $2.0 billion from $1.6 billion. On the other hand, Swiss investors reduced net purchases to $76 million and U.K. investors moderated their net selling to $560 million.

The Japanese Finance Ministry tried to "persuade" Japanese financial institutions to reduce investments in dollar bonds late in the third quarter. Whether based on this persuasion or other factors, Japan's net long-term capital outflow reportedly declined to $3.1 billion in September, compared with a monthly

TABLE III

NET FOREIGN PURCHASES AND TOTAL FOREIGN HOLDINGS
OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1985 Second Quarter		1985 Third Quarter	
	Net Purchases	Estimated Holdings	Net Purchases	Estimated Holdings
Europe	$3,657	$49,759	$2,887	$52,646
Switzerland	190	2,579	76	2,655
West Germany	1,555	20,017	1,956	21,973
United Kingdom	(658)	13,454	(560)	12,894
Asia	7,029	56,943	6,485	63,428
Japan	5,437	26,706	6,880	33,586
"Other Asia"*	597	23,965	(1,971)	21,994
Nonmonetary Int'l & Regional Org.	803	9,922	(2,403)	7,519
All Countries	$13,106	$123,659	$8,346	$132,005

Source: U.S. Treasury

* Treasury has discontinued publication of the estimated holdings of the oil-exporting countries. Figures based on last published figure plus summation of quarterly data.

average of $5.5 billion for the first eight months of 1985.4/ However, Japanese net purchases of Treasuries were stepped up by 27% to an unprecedented $6.9 billion in the third quarter from $5.4 billion in the second. Purchases of $955 million and $252 million (not shown in Table III) by investors in Singapore and Hong Kong, respectively, also added to the $6.5 billion of net purchases from the Asian region.

Offsetting Japanese purchases were net sales of $2.0 billion by the oil-exporting countries, a significant reversal from net purchases of $597 million in the second quarter. The

4/ "Home is where the hurt is," The Economist, 11/9/85.

strains on the economies of the oil-exporting countries are well known. Nevertheless, activity by these countries in U.S. securities (equities, corporate bonds and Treasuries) has been moderate in the first and second quarters. Third-quarter divestitures of Treasuries represents the first large-scale drawing down of reserves evident in the Treasury data for 1985.

U.S. Activity in Foreign Stocks

In the last Foreign Activity Report, we questioned the magnitude of the decline in U.S. purchases of foreign stocks from the first to second quarter. Treasury revised the preliminary second-quarter figure of $25 million to $219 million. Nevertheless, the falloff in U.S. interest in foreign stocks, from a record $1.9 billion in the first quarter, remains excessively steep. We continue to believe that Treasury data, the only fairly timely available source of information on capital flows, should be considered an indication of the trend, not necessarily the magnitude, of investment flows.

The U.S. stock market was not the only one to suffer a setback in the third quarter. Overall, however, most major stock markets continued to gain albeit at a slower pace than earlier in the year. With foreign currencies appreciating vis-a-vis the dollar, U.S. investors stepped up net acquisition of foreign stocks to $987 million. At $3.1 billion for the first nine months of 1985, U.S. net purchases of foreign stocks stand a good chance of reaching the $3.8 billion record set in 1983. InterSec Research Corp. estimates that by the end of 1985, U.S. pension funds had earmarked $27 billion for international investment in fixed-income instruments or equities, compared with $15.1 billion at year-end 1984.

U.S. investors increased net purchases of European stocks to $342 million in the third quarter from $169 million in the second. We would expect that a good part of Treasury's discrepancy in second-quarter numbers was in European activity, thus increases and decreases in net purchases may not be of the magnitude depicted in Table IV. Net purchases of U.K. stocks were boosted to $239 million. The easing of high U.K. interest rates led to an improved investment climate which U.S. investors took advantage of. After making net sales of $69 million in the second quarter, U.S. investors swung to net purchasers of $83 million of Swiss stocks. Changes in Swiss pension laws, creating tax-protected personal retirement accounts, are fueling the already strong bull market, as local pension funds look to equity investment.5/ U.S. investors also made net purchases of $91 million of German stocks according to Treasury data (not shown in Table IV).

5/ "Hitching a Ride on the High-Flying Overseas Markets," Business Week, 12/30/85.

TABLE IV

GROSS ACTIVITY IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1985 Second Quarter		1985 Third Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$4,739	$169	$4,806	$342
France	230	18	235	31
Netherlands	351	(77)	405	(103)
Switzerland	331	(69)	405	83
United Kingdom	3,015	79	2,883	239
Canada	1,335	147	1,437	267
Asia	2,802	(300)	3,511	291
Japan	2,333	(371)	2,935	99
Other	763	203*	847	87
All Countries	$9,639	$219*	$10,601	$987

Source: U.S. Treasury

* Revised data for total net purchase and residual figures only.

U.S. investors retain a healthy interest in Canadian stocks, upping net purchases to $267 million in the third quarter from $147 million in the second. Prospects for both the Canadian economy and stock market gained momentum as the year progressed. Among the best performing sectors of the Toronto stock exchange's industry index was a 53% runup in the retailing index and a 49% rise in Canadian gold mining stocks, which benefited from turmoil in South Africa during the year.6/

U.S. investors swung from a negative position on Japanese stocks in the second quarter to a moderately positive one in the third. Third-quarter net purchases of $99 million contrast with second-quarter net sales of $371 million. Japan's agreement to strengthen the yen vis-a-vis the dollar may call for higher interest rates which could dampen stock market

6/ "For High-Flying Canadian Stocks, Signals Point to Continued Climb," The Wall Street Journal, 1/2/86.

progress. U.S. investors, thus, appear to have taken a hesitant approach to investment in Japanese stocks. U.S. acquisition of Hong Kong stocks mainly accounted for the third-quarter level of net purchases, $291 million, for the Asian region. U.S. investors purchased $156 million of stocks of Hong Kong companies in the third quarter (not shown in Table IV). With the exception of a falloff in mid-year caused by troubles in the banking sector, the Hong Kong stock market climbed somewhat steadily over 1985, gaining 40% in dollar terms by year-end. A bit of uncertainty is expected in the changeover from British to Chinese sovereignty, but the tie to China is expected to enhance the prospects of many Hong Kong companies.

The trend toward internationalization of capital markets is supported by trends in Treasury data in recent years. Foreign gross activity in U.S. equities has spurted from $75.2 billion in 1980 to $109.3 billion through the first nine months of 1985. Similarly, over the same period, U.S. gross activity in foreign stocks has jumped from $17.9 billion to $75.2 billion. Moreover, while foreign investors became large buyers of U.S. stocks in the 1970s, U.S. interest in foreign stocks was modest. The years 1984 and 1985, however, mark a reversal in the long-standing trend of capital flows. In 1984, foreign investors became net sellers of $2.9 billion of U.S. equities and U.S. investors were net purchasers of $1.2 billion of foreign stocks. We expect that foreign investors will once again be net buyers of U.S. stocks in 1985; however, U.S. net investment in foreign stocks will outweigh foreign inflows to the U.S. stock market. Technological innovation, the gradual deregulation of markets worldwide and the easing of restrictions on currency movements have prompted U.S. investors to seek increased portfolio diversification in foreign markets.

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Foreign Activity in U.S. Securities

"Highlights"

1. Foreign net purchases of U.S. equities in 1985, $4.9 billion, did not break the 1981 record of $5.8 billion. However, the magnitude of fourth-quarter net acquisition is unprecedented. Foreign enthusiasm for U.S. equities reached a dramatic $4.1 billion in the last quarter of 1985. Preliminary data indicate foreign investors remained enthusiastic about U.S. equities in this year's first quarter. The pace of acquisition appears to be running close to the fourth-quarter level.

2. Foreign gross activity in U.S. equities, as well as other U.S.-dollar denominated investments, escalated to record levels in 1985. After dipping 9% in 1984 to $122.7 billion from 1983's record of $134.1 billion, foreign gross activity in U.S. equities climbed to a new high of $157.7 billion.

3. Based on exceptional interest from the U.K., foreign investors acquired $39.7 billion of U.S. corporate bonds, including Euro-issues, in 1985.

4. Although foreign interest in U.S. Treasuries was minimal early in 1985, activity in the remainder of the year, particularly by Japanese investors, pushed foreign net purchases to an all-time high of $29.8 billion. Japanese investors acquired the lion's share, with net purchases totaling $18.9 billion or 63% of foreign acquisition of Treasuries in 1985.

5. U.S. net purchases of foreign stocks set a new record in 1985, $3.9 billion. This was almost four-times the 1984 level and a shade past the previous 1983 high of $3.8 billion. Gross activity was also accelerated to a new high. U.S. transactions in foreign stocks increased 47% to $45.1 billion in 1985 from $30.7 billion in 1984.

Introduction

The foreign investor juggles a mix of factors when making the decision to invest in U.S. securities. Among these economic and political factors, the relative strengths of the U.S. dollar and stock market are key. A still-strong dollar and a modestly uptrending stock market at the beginning of 1985 were not enough to convince foreign investors to change their investment posture toward U.S. equities. In 1984, for the first time since 1968, foreign investors were net sellers of U.S. equities and in the first quarter of 1985, foreign investors sold $1.1 billion of equities. However, despite the almost steady fall of the dollar during the remainder of the year, foreign investors returned to U.S. equities as the market rally gained confidence. In the fourth quarter, with the bull market in full force, foreign investors bought an unprecedented quarterly amount of U.S. equities, $4.1 billion. Foreign net purchases totaled $4.9 billion in 1985, in contrast to net sales of $3.0 billion in 1984.

It was a year of extremes for the U.S. dollar. After touching record highs against some currencies early in 1985, the dollar began a decline which, although not without interruption and assisted in part by official intervention, continued through the year. Measured by year-end 1984 to year-end 1985 values, the dollar depreciated between 25% to 29% against most major foreign currencies. The Canadian dollar was the one exception, losing 6% to the U.S. dollar last year.

After a brief upswing early in 1985, stock market progress stalled as economic growth came in below forecast and strong earnings growth failed to materialize. However, as the Federal Reserve responded to a sluggish economy, interest rates declined and the stock market surged. For the year, a handsome gain of about 27% was scored by major stock market indices. Nevertheless, the U.S. market was to be outdone by 14 foreign markets in dollar terms. The gap closed a bit in the first quarter of 1986, with 10 foreign stock markets gaining more than the 13% increase of the U.S. stock market.[1/]

While the dollar continued to lose ground in the first quarter of 1986, the stock market continued to make strong strides. Preliminary data indicate foreigners were net purchasers of U.S. equities in the first quarter of 1986. The pace of acquisition appears to be running close to the fourth-quarter level.

1/ Based on data by Morgan Stanley Capital International Perspective.

Foreign Investors Activity in U.S. Equities

Gross Activity

Foreign interest in U.S. equities, as well as other U.S.-dollar denominated assets, reached record levels in 1985. When foreign gross activity is traced over the past 10 years, the trend toward internationalization of capital markets is dramatically clear (See Chart I). Foreign gross activity in U.S. equities jumped to $157.7 billion in 1985 from $122.7 billion in 1984, thus surpassing 1983's record $134.1 billion by 18%. In addition, foreign transactions have been maintained at an estimated 9%-9.5% of the value of NYSE public trading in 1984 and 1985.

Likewise, U.S. investors have showed escalating interest in foreign stocks (See Chart II). U.S. gross activity in foreign stocks increased 49% to a record $45.9 billion in 1985 from $30.7 billion in 1984. Moreover, the net acquisition pattern in equity investment is shifting somewhat. In 1984 an historic pattern was reversed: U.S. investors became net "exporters" of equity capital. Foreign investors made net sales of $3.0 billion of U.S. equities, while U.S. investors purchased $1.1 billion of foreign stocks. Although this pattern did not persist in 1985 due to foreign fourth-quarter activity, U.S. acquisition of foreign stocks ran 21% less than foreign acquisition of U.S. stocks.

Net Purchases

While foreign net purchases of U.S. equities in 1985, $4.9 billion, did not break the 1981 record of $5.8 billion, the magnitude of fourth-quarter net purchases is unprecedented. Foreign enthusiasm for U.S. equities in the fourth quarter reached a significant $4.1 billion, almost three times the third-quarter level. The most dramatic quarterly pick-up stemmed from the European countries, with net purchases leaping from $869 million to $2.8 billion. Canada was the only major region making net sales, $8 million, of U.S. equities in the fourth quarter.

Given the fourth-quarter euphoria, regional activity in 1985 differs sharply from 1984. In 1984, European and Asian investors were net sellers of a substantial $3.1 billion and $2.4 billion of U.S. equities, respectively. In contrast, European investors purchased $2.1 billion and Asian investors, $551 million in 1985. While Latin American and Caribbean investors escalated net purchases substantially to $1.7 billion, Canadian investors reduced net buying by 79% to $355 million in 1985.

CHART I

FOREIGN ACTIVITY IN US STOCKS
PURCHASES AND SALES
$ BILLIONS
YEARS
75 76 77 78 79 80 81 82 83 84 85
26 34 28 38 44 75 76 80 134 123 158

CHART II

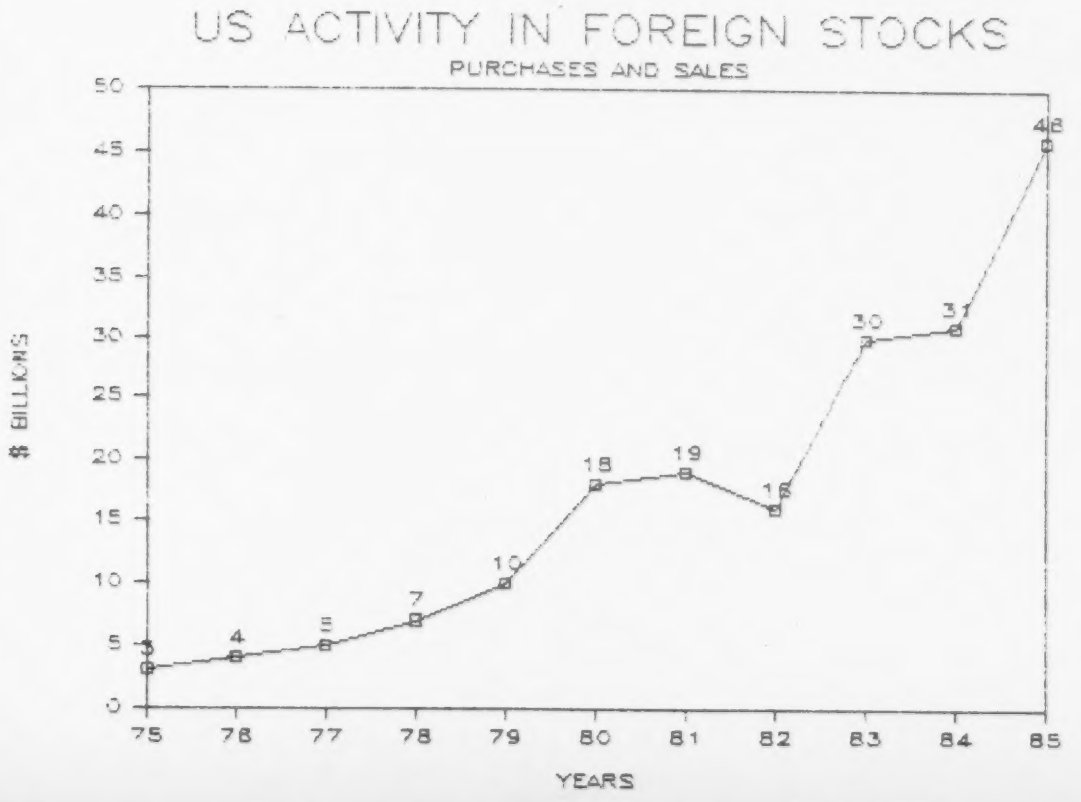

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1984		1985	
	Gross	Net	Gross	Net
Europe	$ 67,580	$(3,074)	$ 82,491	$2,068
Belgium-Luxembourg	2,696	(38)	4,382	185
France	5,657	(405)	6,024	(437)
Germany	6,162	(50)	6,124	730
Netherlands	3,458	(356)	3,953	(122)
Switzerland	20,048	(1,538)	21,537	(75)
United Kingdom	27,515	(677)	37,709	1,674
Canada	16,771	1,695	22,119	355
Latin America & Caribbean	17,432	496	25,065	1,671
Bermuda	5,989	77	9,109	962
Netherlands Antilles	7,025	465	7,590	293
Asia	18,574	(2,370)	24,552	551
Hong Kong	2,798	(536)	3,521	(193)
Japan	2,746	(148)	7,471	298
"Other Asia"*	11,519	(1,993)	11,693	238
Total All Countries	$122,660	$(2,972)	$157,746	$4,921

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Saudi Arabia, the United Arab Emirates

Note: For 1985, net data include latest revisions and gross transactions are unrevised quarterly figures. For 1984, all data are final. This applies to all tables unless otherwise noted.

European Investors

U.K. investors turned their attention to fixed-income instruments, both domestic and U.S., during much of 1985. Relatively high interest rates needed to bolster sterling and contain inflationary pressures made domestic fixed income investment attractive, especially short-term instruments. The U.K. market was slow to catch the enthusiasm that marked many foreign exchanges, climbing a comparably modest 18% over the year. Indeed, the U.K. government is fine-tuning a personal equity plan (PEP) to

spur investment in British stocks. PEP would allow contributions of up to 200 pounds a month with no tax on reinvested dividends or capital gains. Nevertheless, when international investors joined in the U.S. rally, U.K. investors followed suit, purchasing $1.5 billion of equities in the fourth quarter. For 1985, U.K. investors acquired $1.7 billion of U.S. equities in contrast to divestitures of $677 million in 1984.

German investors' confidence in U.S. equities also paralleled the stock market's progress, so that by the fourth quarter German investors were whole-hearted participants. For 1985, net purchases totaled $730 million, in contrast to net sales of $50 million in 1984. West Germany's economy enjoyed stable growth in 1985; corporate profits, a healthy rise; and the stock market, one of the most prosperous year's in its history. Nevertheless, just as caution marks the German approach to U.S. equities, so too does it characterize domestic equity investment. Because of the German reluctance to invest in equities, foreign investors accounted for about half the daily volume on the Frankfurt exchange in 1985.2/

An improved domestic investment climate held the attention of French investors in 1985. These investors made net divestitures of over $400 million of U.S. equities in both 1984 and 1985. Moreover, French investors were the only major European investors to make net sales, $272 million, in the fourth quarter. Although the French stock market came down with the "jitters" in mid-year as election prospects were assessed, performance in the fourth-quarter ranked third among world markets. For 1985, an overall gain of 40% was registered by the French stock market. The French parliamentary elections in March 1986 held no surprises, with the right-wing opposition winning a majority. Prior to the elections, the French markets reached record highs as encouraging economic fundamentals were in-place and several promised reform policies would further stimulate investment. For example, an extension of the loi Monory, which exempts the first FF 500 of dividends from personal tax is anticipated.3/

Swiss investors' net purchases of $513 million of U.S. equities in the fourth quarter were not enough to offset the net sales of the previous three quarters. Net sales of $75 million were made in 1985, in comparison to $1.5 billion in 1984. Switzerland's equity and bond markets boomed in 1985, bolstered in part by the new obligatory pension-fund law and the introduction of innovative financing instruments. In addition, low inflation, stable economic growth and a rising Swiss franc kept Swiss investors focused on home markets.

2/ "Frankfurt Stock Rise Ignored," New York Times, 2/24/86.

3/ "Fair stands the wind for France", The Economist, 2/8/86

Canadian Investors

Canadian investors took a subdued posture toward U.S. equities in 1985. Net purchases of $355 million were made, compared to $1.7 billion in 1984. It is likely that Canadian investors were attracted to the yields available on domestic fixed-income investment. Although the Canadian economy evidenced good performance generally in 1985, relatively high interest rates needed to steady the falling Canadian dollar compounded budget deficit problems. The Canadian government has recently announced actions to reduce the deficit, but declining oil prices have undermined the heavily energy-weighted Canadian stock market.

TABLE II

NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1985 First Quarter	1985 Second Quarter	1985 Third Quarter	1985 Fourth Quarter
Europe	$(1,344)	$(369)	$ 869	$2,841
Belgium-Luxembourg	20	60	64	40
France	(73)	67	(164)	(272)
Germany	(356)	66	232	788
Netherlands	(279)	(117)	80	205
Switzerland	(414)	(91)	(77)	513
United Kingdom	(235)	(356)	691	1,489
Canada	213	(20)	168	(8)
Latin America & Caribbean	389	546	204	602
Bermuda	335	223	211	255
Netherlands Antilles	11	210	(82)	152
Asia	(441)	409	151	404
Hong Kong	(256)	79	83	(99)
Japan	(191)	191	(124)	422
"Other Asia"	(37)	43	142	61
Total All Countries	$(1,137)	$ 529	$1,427	$4,082

Source: U.S. Treasury

Note: Quarterly data unrevised.

Latin American & Caribbean Investors

Net purchases of U.S. equities by Latin American and Caribbean investors jumped to $1.7 billion in 1985, more than three times the 1984 level of $496 million. Steady interest in U.S. equities stemming from Bermuda accounted for the increase. Improvement in the underwriting insurance markets, of which Bermuda ranks as the world's largest "captive" market, may be reflected in the upscaled activity. In addition, to encourage mutual funds and trusts to establish in Bermuda, the method of charging the Bermuda stamp taxes on these entities was liberalized during the year. Investors located in the Netherlands Antilles reduced net purchases by 37% to $293 million from $465 million.

Asian Investors

Asian investors reversed to net buyers of $551 million of U.S. equities in 1985 from net sellers of $2.4 billion in 1984. Japanese investors purchased $298 million of equities in 1985, with fourth-quarter net acquisitions of $422 million offsetting prior net sales. The sharp run-up of the U.S. stock market attracted Japanese investors who were avid purchasers of Treasuries during the year. Reportedly, of Japan's total foreign portfolio of over $100 billion, more than half is composed of Treasury bonds and about a quarter is quoted securities.4/

The large-scale net divestitures of U.S. securities which characterized activity by the oil-exporting countries in recent years moderated in 1985. After making large net sales of equities in both 1983 and 1984, these investors made net purchases of $238 million in 1985. In addition, Hong Kong investors reduced net sales by 64% to $193 million in 1985 from $536 million in 1984.

Foreign Activity in U.S. Corporate Bonds

With the repeal of the 30% foreign withholding tax in 1984, Treasury incorporated foreign purchases of direct Euro-issues into corporate bond capital flow data. Therefore, while foreign acquisition of a hefty $39.7 billion of U.S. corporate bonds in 1985 is not strictly comparable to the $11.9 billion registered in 1984, several other factors augured well for foreign investment in U.S. corporate bonds. We believe, however, that the resurrection of the foreign withholding tax at a rate of 5% as proposed would cause a serious disruption of international capital flows.

A low rate of inflation and declining interest rates spurred foreign interest in corporate bonds. These factors, coupled with sluggish economic growth in the fourth quarter, generated heated speculation that the Federal Reserve would lower interest rates further. Foreign acquisition of corporate bonds gained momentum in the fourth quarter, with purchases of $16.5 billion made in comparison to an average quarterly pace of about $7.8 billion in the first three quarters of 1985.

4/ "Stock exchange lets foreigners play", Euromoney, 3/86

TABLE III

GROSS TRANSACTIONS IN AND NET PURCHASES OF
U.S. CORPORATE BONDS
($ Millions)

	1984		1985	
	Gross	Net	Gross	Net
Europe	$22,915	$11,138	$64,283	$37,241
Belgium-Luxembourg	539	(83)	1,008	213
Germany	4,314	1,556	7,748	2,110
Switzerland	2,691	604	6,460	3,903
United Kingdom	13,930	8,702	46,280	30,502
Asia	6,443	435	12,870	2,018
Japan	1,948	708	6,576	2,978
"Other Asia"	3,944	(464)	4,655	(1,470)
All Countries	$32,983	$11,921	$84,737	$39,747

Source: U.S. Treasury

European investors purchased $37.2 billion of U.S. corporate bonds, with over 80% of this amount bought by U.K. investors. U.K. investors were also the largest foreign purchasers of corporate bonds in 1984, $8.7 billion compared with $30.5 billion in 1985. Over much of last year, the interest rate differential between U.S. and U.K. corporate bonds favored U.S. investment and inflation in the U.S. ran below that of the U.K. In addition, Swiss and German investors stepped up net purchases to $3.9 billion and $2.1 billion of corporate bonds in 1985 from $604 million and $1.6 billion, respectively, in 1984.

Japanese enthusiasm for U.S. fixed income instruments extended to corporate bonds, with net purchases totaling $3.0 billion in 1985. Offsetting net purchases from Japan were net sales of $1.5 billion from investors in the oil-exporting countries. Nevertheless, there was a distinct change in 1985 from recent years in the activity pattern of the oil-exporting countries in U.S.-dollar denominated assets. For example, net divestitures of corporate and Treasury bonds by these countries were about half the 1984 level. In addition, the oil-exporting countries purchased a minimal amount of equities in 1985, in contrast to net sales of $2 billion in 1984. Activity in the markets covered in this Report would support the assumption that Saudi oil-income has not dropped as sharply as suggested nor are financial reserves being depleted as quickly as in previous years.5/ Steep cutbacks have been made in domestic projects, much oil is sold on a net-back basis, and the value of equity investments would have surged with world markets.

5/ "Why the Saudis Won't Back Down Soon," Wall Street Journal, 4/8/86

Foreign Activity in U.S. Treasury Notes & Bonds

Although foreign interest in U.S. Treasuries was only $201 million in the first quarter of 1985, activity in the remainder of the year, particularly by Japanese investors, pushed foreign net purchases to a record $29.8 billion. This compares with the previous all-time high of $22.8 billion set in 1977 and 1984's level of $21.5 billion. At the end of 1985, foreign investors held an estimated $140.2 billion of Treasuries.

Japanese enthusiasm for Treasuries in 1985 captured much attention. These investors purchased an unprecedented $18.9 billion or 63% of the total foreign net purchases of Treasuries in 1985, as compared with $6.3 billion or 29% of the total in 1984. The yield differential on government bond issues favoring U.S. over Japanese issues narrowed over the year from about 525 basis points to 339 basis points.[6/] So too, the

TABLE IV

NET FOREIGN PURCHASES AND TOTAL FOREIGN HOLDINGS OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1984		1985	
	Net Purch.	Estimated Holdings	Net Purch.	Estimated Holdings
Europe	$11,041	$ 46,523	$ 3,962	$ 50,485
Switzerland	656	1,774	760	2,534
West Germany	2,929	20,219	1,917	22,136
United Kingdom	5,188	13,703	(2,143)	11,560
Asia	2,431	48,457	20,776	69,233
Japan	6,289	20,200	18,859	39,059
"Other Asia"	(6,270)	23,140[1/]	(1,640)	21,500[1/]
Nonmonetary Int'l & Regional Organizations	5,003	10,117	483	10,600
All Countries	$21,515	$110,447	$29,767	$140,214

Source: U.S. Treasury

1/ Treasury has discontinued publication of estimated holdings of the oil-exporting countries. Figures based on last published figure plus summation of quarterly data.

6/ Yield comparisons based on data contained in World Financial Markets, Morgan Guaranty Trust Co.

dollar fell during the year by some 20% vis-a-vis the yen. Nevertheless, the size, diversity and liquidity of U.S. markets acted as a powerful magnet for Japanese investment. The Japanese have been slow to offer instruments which match those available in U.S. markets. However, in conjunction with the liberalization of the Japanese financial system, the Japanese authorities have announced an extension of maturities and lower minimum denominations in the hopes of providing more investment opportunities in domestic markets.

Thus, for the total Asian region, Japanese investors sent net Treasury purchases soaring to $20.8 billion in 1985 from $2.4 billion in 1984. In addition, while investors from the oil-exporting countries remained net sellers of Treasuries, sales were sharply cutback from the 1984 level. These investors sold $1.6 billion of Treasuries in 1985, compared to $6.3 billion in 1984. Also contributing to the high level of Asian activity in 1985 were net purchases of over $1 billion by investors located in both Hong Kong and Singapore (not shown in Table IV).

European net acquisition of Treasuries in 1985 was mitigated by fourth-quarter activity, given the coordinated selling efforts of the Group of Five. European net purchases of $4.0 billion in 1985 compare with $11.0 billion in 1984. Large sales of $1.2 billion stemming from the U.K. in the fourth quarter contributed to the overall disint rest of most of the year. Although the yield differential between U.S. and U.K. governments favored U.S. issues by a relatively narrow margin over most of 1985, U.K. investors clearly preferred corporate bonds for U.S. fixed income investment. In addition, activity stemming from the central bank would have dampened net purchases.

While Swiss investors increased net Treasury purchases by 16% to $760 million in 1985, German investors cut back net purchases by 35% to $1.9 billion. Norwegian investors became large purchasers of Treasuries in 1985, $1.4 billion, in comparison to $231 million in 1984 (not shown in Table IV).

U.S. Activity in Foreign Stocks

The attraction of U.S. investors to foreign stocks in 1985 set a new record, $3.9 billion in net purchases. This was almost four-times the 1984 level and a shade over the previous 1983 high of $3.8 billion. Upscale interest in foreign stocks was also evident in the record level of gross activity. Gross activity rose 47% to $45.9 billion in 1985 from $30.7 billion in 1984. U.S. enthusiasm for foreign stocks extended to all major regions. U.S. investors acquired $1.8 billion of European stocks, $1.2 billion of Canadian stocks, and $690 million of stocks of companies located in Asia.

TABLE V

GROSS TRANSACTIONS IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1984		1985	
	Gross	Net	Gross	Net
Europe	$13,509	$ 923	$21,039	$1,751
France	1,013	123	1,219	301
Netherlands	1,306	(106)	1,899	(31)
Switzerland	1,321	79	1,619	279
United Kingdom	7,925	627	12,907	617
Canada	4,427	(175)	6,824	1,220
Asia	10,742	(38)	14,178	690
Japan	9,099	(383)	11,771	129
Other	2,043	379	3,882	244
All Countries	$30,721	$1,089	$45,923	$3,905

Source: U.S. Treasury

Note: For 1985, total all countries revised; other data unrevised.

U.S. net purchases of European stocks soared 90% to $1.8 billion in 1985 from $923 million in 1984. About $300 million each of stocks of French, Swiss and German companies were purchased. The lion's share of European investment, $617 million, went to U.K. companies.

Acquisition of French stocks was in tandem with the course of the French stock market, which lagged at the beginning of the year but jumped almost 30% in the fourth quarter. With the assessment that the expected dual-party government would swing into place with relative ease, U.S. investors made net purchases of $240 million of French stocks in the final quarter of the year. Similarly, heightened U.S. interest in Swiss stocks came with Swiss market gains of over 30% in both the third and fourth quarters. U.S. net purchases of Swiss stocks totaled $279 million in 1985, with $176 purchased in the fourth quarter. Another market in which U.S. investors acquired almost $300 million of stocks was West Germany's (not shown in Table V). Foreign investors were major players in German capital markets in 1985, buying twice the level of German shares as in 1984 and purchasing some one-third of net German bond sales in the first three quarters of 1985.7/

7/ "Foreign investor's call the tune in German capital markets," Financial Times, 11/22/85.

U.S. interest in British stocks waned during the fourth quarter as expected oil price declines threatened to weaken sterling and force an increase in U.K. interest rates. Although interest rates did bounce up near the end of the year, the U.K. stock market suffered only a minimal setback. Thus, despite net sales in the fourth quarter, U.S. investors' net purchases of U.K. stocks in 1985 were on par with the 1984 level, over $600 million. However, future interest in U.K. stocks is uncertain. Reportedly, American buying of British stocks has slowed considerably after the March announcement of a proposed 5% tax on the conversion of British shares to ADRs.[8/]

Although the interest was not reciprocated, U.S. investors acquired $1.2 billion of Canadian stocks in 1985. Overall, the performance of the Canadian market did not match that of the U.S., but certain sectors chalked up above-average gains. We would expect that U.S. investors were selective buyers, concentrating on those industries that would benefit from the lower Canadian dollar and easing of interest rates toward the end of the year.

TABLE VI

NET PURCHASES OF
FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1985 First Quarter	1985 Second Quarter	1985 Third Quarter	1985 Fourth Quarter
Europe	$ 840	$169	$342	$400
France	12	18	31	240
Netherlands	146	(77)	(103)	3
Switzerland	89	(69)	83	176
United Kingdom	372	79	239	(73)
Canada	363	147	267	443
Asia	685	(300)	291	14
Japan	573	(371)	99	(172)
Other	(19)	203	87	(71)
All Countries	$1,869	$219	$987	$786

Source: U.S. Treasury

Note: Quarterly data unrevised.

8/ "Most World Markets Soared in First Quarter of the Year," The New York Times, 3/31/86.

U.S. investors' net purchases of Japanese stocks, $129 million in 1985, resulted mainly from first-quarter activity. For the remainder of the year, U.S. investors took a hesitant approach as market direction became increasingly uncertain and Japanese "blue chips," the preferred investment of foreigners, were reportedly overvalued. However, declining oil prices and a rising yen have prompted a return by foreign investors to Japanese markets in 1986. The Ministry of Finance reports foreigners were net purchasers of $253 million of stocks in February, the first time since July 1985.9/ U.S. net purchasers of stocks of Hong Kong companies, $403 million, accounted for over half of purchases of stocks of Asian companies (not shown in Table V). The Hong Kong market put in a strong performance in 1985, with the proximity to China brightening the prospects of many Hong Kong companies. However, the Hong Kong stock market back tracked over 5% in the first quarter of 1986.

Carolyn Hildebrandt
Assistant Vice President

9/ "Tokyo Shares End Fiscal Year With Big Gains," Wall Street Journal, 4/1/86.

SIA

Foreign Activity

An Analysis of Foreign Participation in the U.S. Securities Markets
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Foreign Activity in U.S. Securities

"Highlights"

1. In the first quarter of 1986, the two key factors that foreign investors in U.S. equities focused on in 1985 -- the dollar and the stock market -- followed the same course as in the fourth quarter of 1985. The stock market continued to advance, the dollar continued to decline, and foreign investors continued to purchase record amounts of U.S. equities. First-quarter foreign net purchases reached both an annual-and-quarterly record shattering $6.4 billion.

2. Foreign gross activity (purchases plus sales) in U.S. equities also reached a fevered-pitch. From the fourth quarter's all-time high of $49.0 billion, foreign gross transactions increased 21% to $59.3 billion.

3. Foreign net purchases of U.S. corporate bonds were reduced by 29% to $11.4 billion from a record $16.0 billion in the fourth quarter of 1985. Record purchases were sparked in the final quarter as speculation intensified that the Federal Reserve would lower interest rates. However, the first quarter brought mounting concern over the steep fall of the dollar, thus limiting expectations of lower interest rates.

4. First-quarter net purchases of U.S. Treasuries were on par with the fourth-quarter level, $8.5 billion. However, there was a major shift in key players in this market. U.K. investors purchased a large $2.8 billion of Treasuries, while Japanese net purchases of $880 million were modest in comparison to their 1985 activity.

5. U.S. investors reciprocated in like kind the record first-quarter interest foreign investors showed in U.S. equities. U.S. net purchases of foreign stocks reached an all-time quarterly high of $2.1 billion and gross transactions followed suit. U.S. gross activity in foreign stocks climbed to $20.2 billion, already reaching 44% of 1985's record $45.9 billion.

Introduction

As the U.S. stock market climbed in 1985, so too did foreign investment in U.S. equities. In the fourth quarter of the year, with the bull market in full force, foreign investors purchased an unprecedented quarterly high of $4.1 billion of U.S. equities. The declining fortunes of the U.S. dollar appeared to cast nary a shadow over foreign enthusiasm for U.S. investment. In the first quarter of 1986, the stock market continued to rally, the dollar continued to fall, and foreign investors continued to purchase record amounts of U.S. equities. Foreign net purchases of equities jumped 54% from the fourth-quarter level to an annual-and-quarterly record shattering $6.4 billion. In comparison, net purchases of $5.8 billion in 1981 set the annual record.

The U.S. dollar continued its almost year-long slide against most major currencies in the first quarter, amidst speculation along the way that policy actions might be taken to support the dollar. The dollar suffered the sharpest depreciation, about 13%, against the yen. In late March, a Congressional proposal to reimpose a withholding tax on interest earned by foreign holders of U.S. securities helped explain the dollar's collapse to a 40-year low against the yen.1/ In addition, the French franc, German mark, and Swiss franc all advanced between 4% and 6% against the dollar. Sterling showed strength late in the quarter, gaining 2.5%, while the Canadian dollar held steady.

However, the foreign investor was compensated for dollar depreciation by market appreciation. After its outstanding fourth-quarter performance, the U.S. stock market paused in January and then went on to score strong gains in the remainder of the first quarter. While periodically touching new highs, the DJI Average climbed by over 17%, and both the S&P 500 and the NYSE Composite indices rose by over 13%. Notable as the performance of the U.S. market was, it was outdone by several major foreign exchanges, including France, Japan, and the U.K.2/ Nevertheless, foreign investors clearly felt a strong attraction to U.S. equities.

The two key factors foreign investors have been focusing on both suffered minor setbacks in the first two months of the second quarter. The dollar continued its fall against the

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1/ Foreign Exchange Market Trends, Irving Trust Company, 3/20/86.

2/ Based on data by Morgan Stanley Capital International Perspective.

major currencies in April, but strenghtened late in May on favorable economic news. The stock market rally took a breather in April and went on to new highs in May. Preliminary data indicate that March's high level of foreign net purchases was sustained in April, around $2.9 billion. We would expect that foreign investors will be net purchasers of a substantial amount of U.S. equities in the second quarter, albeit below the exceptional $6.4 billion of the first quarter.

Foreign Investors Activity in U.S. Equities

Gross Activity

In 1985, foreign interest in U.S. securities escalated to record levels, with gross transactions in U.S. equities reaching $157.7 billion. The fevered-pitch of gross activity continued in the first quarter of 1986. From the fourth quarter's record high of $49.0 billion, foreign gross activity in U.S. equities increased 21% to $59.3 billion. Although it is too early to "guesstime" 1986 levels, should gross transactions be maintained at this pace, the $200 billion mark could easily be surpassed.

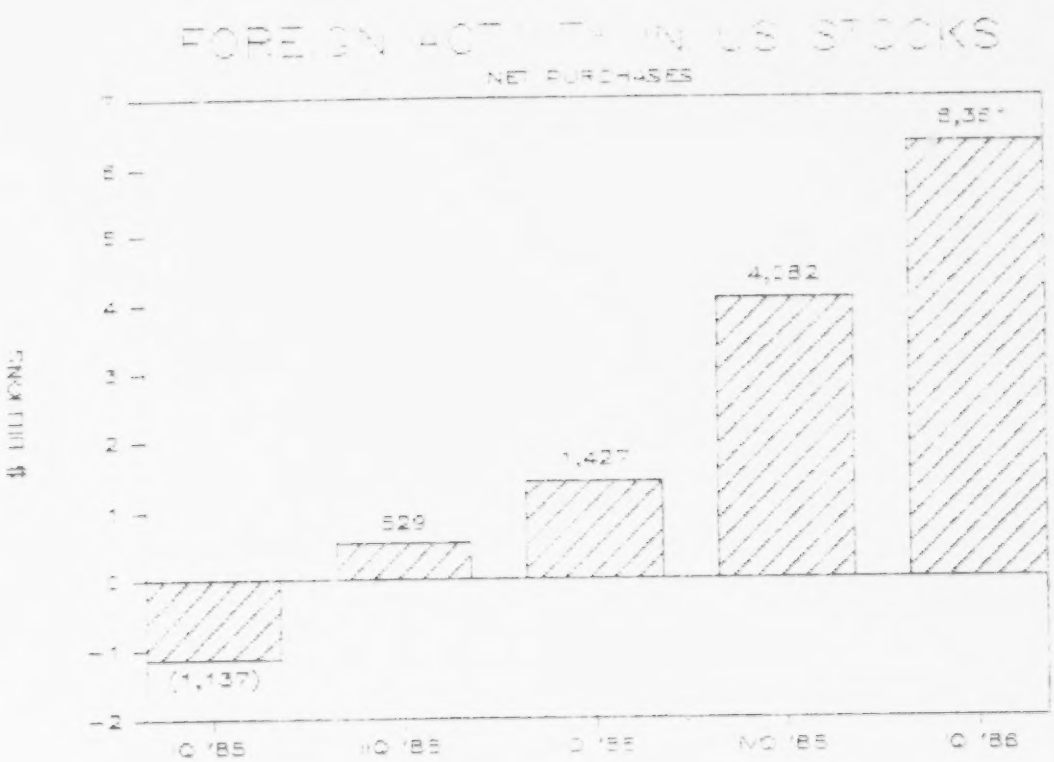
All major regions stepped up activity in U.S. equities in the first quarter. The largest increase in gross transactions, 28%, stemmed from Europe, with activity reaching $33.5 billion. Swiss investors boosted activity by 42% to $9.6 billion, while increases by most other major European countries fell in a range of 24% to 33%. Following close behind the upscaled activity of European investors, Asian investors pushed transactions up by 25% to $9.3 billion. Both Canadian and Latin American and Caribbean investors increased gross activity by 6% to $7.5 billion and $7.6 billion, respectively.

Net Purchases

Foreign investors went on a buying spree in the U.S. equities market in the last quarter of 1985, acquiring a record $4.1 billion. That buying spree became even more intense in the first quarter of 1986. Net purchases of U.S. equities in the first three months of 1986 reached an astonishing $6.4 billion, thus surpassing both the fourth-quarter 1985 quarterly record and the 1981 annual record of $5.8 billion.

The enthusiasm of U.K. and Swiss investors accounted for $3.7 billion, or 58%, of total first-quarter net purchases. On the whole, European investors' net purchases rose 68% to $4.8 billion from $2.8 billion in the final quarter of 1985. Net purchases by Asian investors increased to $860, more than two-times the previous quarter's level. In addition, Canadian investors swung from net sellers of $8 million to net purchasers of $139 million in the first quarter. Latin American and Caribbean investors were the only ones to reduce net purchases, as the fourth-quarter level of $638 million was cut back by 46% to $344 million.

CHART I



European Investors

In their traditional role, U.K. investors accounted for the major share of European net purchases of U.S. equities in the first quarter. Net purchases escalated 52% to $2.3 billion from $1.5 billion in the fourth quarter of 1985. Although disputed by the funds themselves, British pension funds are reportedly "cash rich", with estimates of cash as high as one-third of total assets. Last year's asset growth was placed at 17% and some 28% of this new money found its way into overseas equity markets.3/ However, there was little British enthusiasm for U.S. stocks until the latter half of the year. Given both a "cash rich" position and a reported 100% turnover rate for foreign shares, British pension funds may have been fueling the upswing in U.K. investment in U.S. equities.

3/ "British pension funds," The Economist, 4/26/86.

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1985 Fourth Quarter		1986 First Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$26,109	$2,841	$33,494	$4,770
Belgium-Luxembourg	1,478	40	1,549	135
France	1,642	(272)	2,036	(156)
Germany	2,038	788	2,711	598
Netherlands	1,165	205	1,458	396
Switzerland	6,776	513	9,618	1,406
United Kingdom	11,951	1,489	14,861	2,269
Canada	7,072	(8)	7,469	139
Latin America & Caribbean	7,174	638	7,632	344
Bermuda	2,259	279	2,178	4
Netherlands Antilles	2,052	164	2,312	175
Asia	7,404	404	9,254	860
Hong Kong	1,049	(99)	1,431	41
Japan	2,670	422	3,402	348
"Other Asia"*	3,191	61	3,765	316
Total All Countries	$49,027	$4,118	$59,271	$6,361

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

With booming domestic equity and capital markets in 1985, Swiss investors did not focus on U.S. equities until the fourth quarter, when net purchases of $513 million were made. However, in the first quarter of 1986, net purchases nearly tripled to $1.4 billion. While the Swiss economy is set to chalk up another year of healthy growth, an element of uncertainty has come into the picture. Exports to the U.S. were an above-average 10% in 1985, thus contributing to a bullish element in Switzerland's strong export showing.[4/] The depreciation of the dollar mitigates this growth factor, while the appreciation of the franc against some European currencies has given rise to questions of overvaluation.

4/ "Switzerland," Financial Times, 4/30/86.

Perhaps reflecting this element of uncertainty, the Swiss stock market stagnated during the first quarter of 1986.

Similar to Switzerland, Germany enjoyed active equity and capital markets in 1985, supported in large part by foreign investors. Bustling domestic markets coupled with the German preference for fixed income investment kept German investors relatively cool to U.S. equities until the fourth quarter. Although German investors cut back net purchases of U.S. equities by 24% in the first quarter to $598 million from $788 million in the previous quarter, this level of interest in U.S. equities by German investors can still be considered exceptional.

As in the fourth quarter, French investors were the only major European investors to take a negative investment posture toward U.S. equities. However, net selling was reduced by 43% to $156 million in the first quarter from $272 million. Following a prosperous 1985, the French stock market was in the top three best performing world markets in the first quarter of 1986. In addition, the new conservative government is beginning to make good on its promise to encourage investment and stimulate the economy. After the realignment of the EMS currencies in April, several deregulatory steps were taken including a relaxing of exchange controls, which encompassed lifting the premium French residents had to pay to purchase foreign securities.5/ Second quarter data will give an indication if this measure effects French investors' attitude toward U.S. equities.

Canadian Investors

Canadian investors were among the few investors from major countries to make net sales of U.S. equities in fourth-quarter 1985, $8 million. In the first quarter, Canadian investors reversed their investment position and made net purchases of $139 million. By comparison with net purchases of $1.7 billion in 1984, however, Canadian activity remains subdued. The negative effect of declining oil prices on certain sectors of the Canadian economy and the appearance of the first current account deficit since 1983 have overshadowed a basically favorable economic outlook. The Canadian government allowed interest rates to rise over the first quarter to counter pressure against the Canadian dollar. Given yields of over 12% on certain domestic instruments, Canadian investors continued to show only modest interest in U.S. equities.

Latin American & Caribbean Investors

Net purchases of U.S. equities by Latin American and Caribbean investors dropped 46% in the first quarter to $344 million from $638 million in the fourth quarter of 1985.

5/ "France Unveils Further Measures Meant to Encourage Investing, Boost Economy," Wall Street Journal, 5/16/86.

Precipitating this drop was a steep fall in the level of net purchases by investors located in Bermuda to only $4 million from $279 million in the previous quarter. This sharp pullback is unusual, as net purchases from Bermuda consistently averaged over $200 million quarterly in 1985. Net purchases from the Netherlands Antilles increased by 7% to $175 million in the first quarter. Thus, accounting for the difference in total net purchases from the region was net purchases of between $30 million and $45 million from four countries not shown in the table.

Asian Investors

First-quarter net purchases of U.S. equities by Asian investors jumped to two times the fourth-quarter level, $860 million compared with $404 million. Upscaled interest by the oil-exporting countries accounted for the increase, with investors from these countries making net purchases of $316 million compared with $61 million in the fourth quarter. On the other hand, Japanese investors reduced net purchases moderately, 18%, from the heightened fourth-quarter level of $422 million to $348 million.

Foreign Activity in U.S. Corporate Bonds

Foreign net purchases of U.S. corporate bonds, including Euro-issues, gained momentum in the fourth quarter of 1985 as speculation grew that the Federal Reserve would lower interest rates. Yields on U.S. corporate bonds after increasing in January drifted down over the first quarter, but concerns over the sharp decline of the dollar limited speculation that the central bank would take action to ease credit conditions. Foreign investors subsequently took a cautious approach to investment in U.S. corporate bonds, reducing net purchases by 29% to $11.4 billion in the first quarter from a substantial $16.0 billion in the previous quarter. Even at $11.4 billion, foreign net purchases of corporate bonds were still some 46% above the average acquisition pace of $7.8 billion in the first three quarters of 1985.

European investors reassessed their position in U.S. corporate bonds in the first quarter. Net purchases were reduced by 35% to $9.4 billion from $14.4 billion in the last quarter of 1985. The acceleration of the worldwide bond market rally substantially altered international yield and value relationships, as the movement among various markets and sectors was very different.6/ Swiss investors reduced net purchases of U.S. corporate bonds by 34% to $1.3 billion, while U.K. investors curtailed net purchases by 24% to $8.0 billion.

6/ "International Relative Value Bimonthly", Salomon Brothers, 4/86.

TABLE II

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS
($ Millions)

	1985 Fourth Quarter		1986 First Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$22,787	$14,377	$24,195	$9,377
Belgium-Luxembourg	206	28	258	(14)
France	435	(4)	498	3
Germany	2,744	1,654	2,409	(27)
Switzerland	2,764	1,985	2,106	1,310
United Kingdom	16,163	10,484	18,329	7,965
Asia	4,190	1,231	5,275	2,193
Japan	2,515	1,265	3,544	1,886
"Other Asia"	1,098	(244)	1,194	238
Total All Countries	$29,291	$16,023	$32,154	$11,390

Source: U.S. Treasury

However, German investors made a sharp turnaround, from net purchasers of $1.7 billion to net sellers of $27 million. Data on German capital outflows for bond investment for the first two months of 1986 show that investors were not only reassessing the U.S. market but other foreign bond markets as well. German investors were net sellers of foreign bonds in January and purchasers of a minimal amount in February in comparison to the pace of 1985.

Although Japanese investors all but deserted the U.S. Treasury market in the first quarter, they stepped up their interest in corporate bonds by 49%. Japanese net purchases rose to $1.9 billion from $1.3 billion in the last quarter of 1985. Japanese investors have a well-publicized preference for U.S. fixed-income securities, particularly U.S. Treasuries. Given that the decline in corporate bond yields lagged that of Treasuries, Japanese investors shifted their attention to the corporate bond market. Also contributing to the $2.2 billion of Asian net purchases of corporate bonds in the first quarter was the swing by the oil-exporting countries to net purchasers of $238 million.

Foreign Activity in U.S. Treasury Notes & Bonds

With Japanese investors taking the lion's share, foreign net purchases of U.S. Treasury notes and bonds totaled almost $30 billion in 1985. Although the pace of net foreign acquisition remained almost the same from fourth-quarter 1985 to first-quarter 1986, $8.3 billion to $8.5 billion, there was a major change in key foreign players in the Treasury market.

Both changing interest rate differentials and the falling dollar in part explain the shift in foreign interest in Treasuries. At the beginning of 1985, yields on U.S. Treasuries versus similar Japanese instruments favored U.S. investment by about 500 basis points. The differential narrowed to 338 basis points at the end of 1985 and was further squeezed to 270 basis points by the bond market rally of the

TABLE III

NET FOREIGN PURCHASES AND TOTAL FOREIGN HOLDINGS
OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1985 Fourth Quarter		1986 First Quarter	
	Net Purchases	Estimated Holdings	Net Purchases	Estimated Holdings
Europe	$(1,514)	$50,441	$3,739	$54,180
Switzerland	(150)	2,534	205	2,739
West Germany	217	22,136	913	23,049
United Kingdom	(1,267)	11,517	2,801	14,318
Asia	6,061	69,296	221	69,517
Japan	5,571	39,059	880	39,939
"Other Asia"	(487)	21,564	(686)	20,878
International & Regional Org.	3,087	10,600	3,204	13,804
All Countries	$8,313	$140,233	$8,500	$148,733

Source: U.S. Treasury

Note: Treasury has discontinued publication of the estimated holdings of foreign countries. Figures based on last published figure plus summation of quarterly data.

first quarter.7/ The diminished yield advantage of Treasuries against the Japanese market and several other European markets, coupled with an almost 13% appreciation of the yen vis-a-vis the dollar, prompted Japanese investors to reassess their investment strategy in the first quarter. Nevertheless, despite intense speculation as to the extent of Japanese participation in the Treasury market, Japanese investors reportedly were large purchasers in the Treasury's May financing.

Relative to fourth-quarter Japanese net purchases of $5.6 billion of Treasuries, the $880 million acquired in the first quarter was modest. The dramatic reduction in net purchases by Japanese investors plus a 41% increase in net sales by the oil-exporting countries to $686 million brought net activity by the Asian region to $221 million. This is in stark contrast to net purchases of over $6 billion in the last quarter of 1985.

On the other hand, European investors made net purchases of $3.7 billion of Treasuries in the first quarter in comparison with net sales of $1.5 billion in the fourth quarter. Both Swiss and German investors showed increased interest in Treasuries, making net purchases of $205 million and $913 million, respectively. However, the dramatic reversal of investment position by U.K. investors accounted for the bulk of first-quarter net purchases.

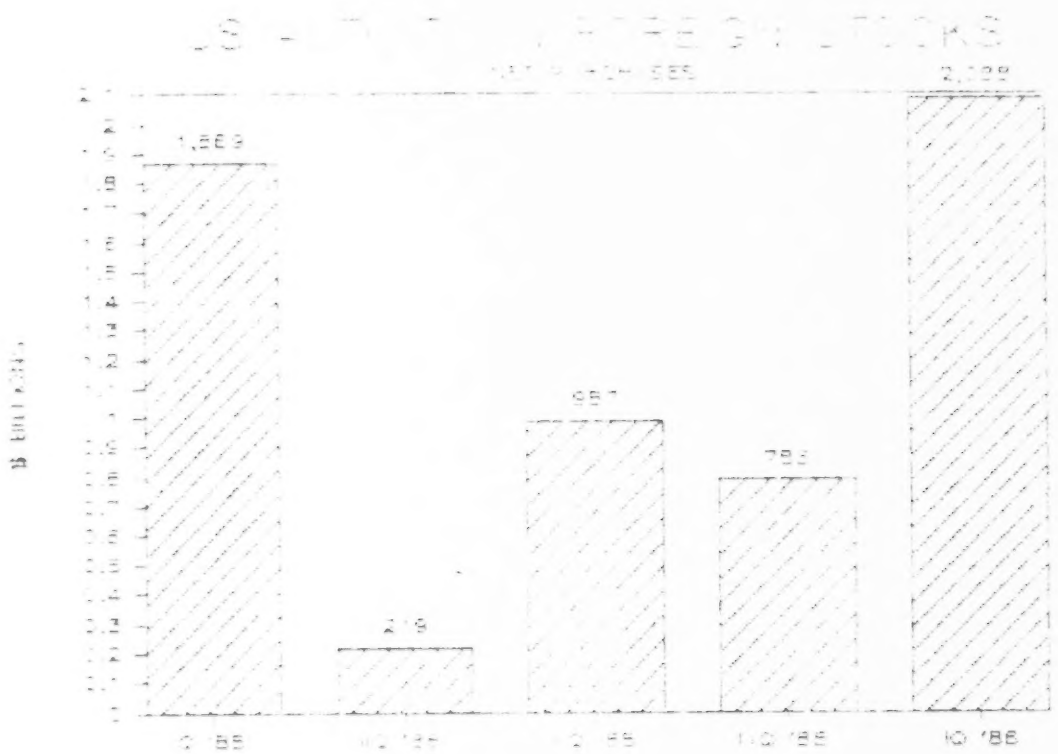
U.K. investors purchased $2.8 billion of Treasuries in the first quarter, compared to net sales of $1.3 billion in the fourth quarter. Interest rate differentials do not explain the dramatic swing by U.K. investors. The 86 basis point advantage that U.K. government issues held over Treasuries at year-end 1985 widened to 122 basis points by the end of March. However, the implications of falling oil prices weighed heavily on the British economic outlook and sterling at the beginning of the first quarter, and the dollar actually gained on the pound in January.

U.S. Activity in Foreign Stocks

U.S. investors reciprocated in like kind the record quarterly interest foreign investors showed in U.S. equities. U.S. net purchases of foreign stocks reached an all-time quarterly high of $2.1 billion in the first quarter of 1986, a shade past the previous record of $1.9 billion set in the first quarter of 1985. U.S. net acquisitions of foreign stocks reached a record $3.9 billion in 1985, with net purchases of $786 million made in the last quarter. First-quarter 1986 net purchases represented over 2.5 times the final quarter's level. Also hitting a record quarterly level, U.S. gross transactions in foreign stocks were $20.2 billion, already equal to 44% of 1985's record gross activity of $45.9 billion.

7/ Yield comparisons based on data in World Financial Markets, Morgan Guaranty Trust Company.

CHART II



The dramatic upscaling of net purchases of Japanese stocks fueled the increase in total first-quarter net activity. U.S. investors swung from net sellers of $172 million of Japanese stocks in the fourth quarter of 1985 to net purchasers of $1.1 billion in the first quarter. Accounting for U.S. enthusiasm in the first quarter were: an overall gain of 24% by Japanese stocks, prospects of significant beneficial economic consequences from falling oil prices, and sharp appreciation of the yen vis-a-vis the dollar.

U.S. net purchases of European stocks were increased 39% to $556 million in the first quarter from $400 million. A reversal in attitude toward U.K. investment was the main contributor to the uptrend, as U.S. investors reduced interest in stocks of several other countries. U.S. investors bought $360 million of U.K. stocks in contrast to net sales of $73 million in the fourth quarter. By the end of the first quarter, it was evident that the U.K. economy had weathered the scare of declining oil prices well, with the pound holding steady and the stock market gaining almost 19%. U.S. acquisition of French stocks, albeit down 17% from fourth-quarter net purchases of $240 million, remained at a heightened

TABLE IV

GROSS ACTIVITY IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1985 Fourth Quarter		1986 First Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$7,536	$400	$11,326	$556
France	502	240	813	199
Germany	644	46	1,489	125
Netherlands	849	3	889	(281)
Switzerland	562	176	677	43
United Kingdom	4,495	(73)	6,808	360
Canada	2,463	443	2,444	536
Asia	4,080	14	5,302	1,302
Japan	3,250	(172)	4,531	1,097
Other	845	(71)	1,138	(306)
All Countries	$14,924	$786	$20,210	$2,088

Source: U.S. Treasury

level. With the French market running up at a quarterly pace of almost 35%, U.S. investors made net purchases of $199 million. In contrast, given the doldrums suffered by the Swiss market in the first quarter, U.S. investors reduced net purchases to $43 million from $176 million in the final quarter of 1985.

We have added Germany to Table IV, given the marked interest U.S. investors showed in German shares in 1985. Net purchases of $300 million of German stocks were made in 1985, on par with purchases of French and Swiss stocks. Moreover, although the uptrend in the German market slowed significantly in the first quarter, U.S. investors made net purchases of $125 million of German stocks.

Canadian stocks drew the most interest from U.S. investors in 1985, with net purchases of $1.2 billion made. That interest continued in the first quarter of 1986, with net purchases upscaled 21% to $536 million from $443 million in the fourth quarter. We believe first-quarter buying was selective,

as was the case in 1985. While the oil-price declines could undermine certain sectors of the economy, other areas continue to show strength. Real GNP growth has clipped along at over 5%, industrial production is running around 5%, and inflation has been kept below 4%.[8/]

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8/ Foreign Exchange Market Trends, Irving Trust Company, 5/29/86.

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SIA

Foreign Activity

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Foreign Activity in U.S. Securities

"Highlights"

1. Starting with the fourth quarter of 1985, foreign net purchases of U.S. equities set three consecutive quarterly records. Net purchases increased 10% in the second quarter of this year to reach a new quarterly record of $7.0 billion. At the half-year mark, foreign net purchases of U.S. equities amounted to an impressive $13.4 billion. This compares to 1981's annual high of $5.8 billion.

2. Gross activity has followed suit. In the second quarter, foreign transactions in U.S. equities jumped 22% to $72.1 billion from $59.3 billion in the first quarter. Thus, gross transactions in the first half of 1986, $131.4 billion, already represent 83% of the 1985 annual high of $159.0 billion.

3. Foreign net purchases of U.S. corporate bonds increased 11% in the second quarter to $12.6 billion from $11.4 billion in the first quarter. Corporate bond yields peaked in May, coinciding with exceptionally large monthly net purchases of $6.2 billion.

4. Foreign holdings of U.S. Treasuries increased by $9.1 billion, or 8%, to $157.9 billion in the second quarter. Investors from Japan and the oil-exporting countries acquired over $1 billion each, showing distinctly more interest than in the first quarter of the year.

5. Although there were dramatic shifts in investment patterns, U.S. investor interest in foreign stocks was maintained at the first-quarter record level of $2.1 billion in the second quarter. After making net purchases of over $1 billion of Japanese stocks in the first quarter, U.S. investors focused their attention on European equities in the second quarter.

Introduction

Although other economic and political factors are considered, the main factor in the foreign investor's investment decision in recent quarters appears to be the strength of the U.S. stock market. Despite the dismal performance of the dollar, foreign capital invested in U.S. equities reached record levels for three consecutive quarters. In the last quarter of 1985, foreign net purchases hit an unprecedented quarterly high of $4.1 billion. Foreign enthusiasm escalated in the first quarter of 1986, sending net purchases to a quarterly-and-annual record shattering $6.4 billion. The record-setting trend continued in the second quarter. With notable shifts in investment patterns, foreign net purchases of U.S. equities increased 10% to $7.0 billion.

Expectations that the U.S. economy would steam ahead at the hearty pace of the first quarter diminished quickly as the second quarter progressed. Mixed signs accumulated that the U.S. economy was slowing, adding further pressure to speculation of interest rate cuts. This speculation was offset somewhat by concerns over the continued fall of the dollar. The stock market's climb to record highs was not without reflection of this uncertainty.

The U.S. stock market continued to advance in the second quarter, albeit not with the momentum nor the even strides of the first quarter. The market's second-quarter gains rest largely on activity during May. The NYSE composite index rose by 4.5% in the second quarter, compared to a first-quarter increase of 13%. The DJI Average and the S&P 500 climbed by about 4%. Paralleling the slowdown of the U.S. market, most major foreign stock exchanges also lost the fevered pitch of the first quarter and made comparatively modest strides.

Despite a show of strength in May, the dollar continued to lose ground to the major foreign currencies in the second quarter. The yen, Swiss franc and German mark chalked up gains ranging between 7% and 9% against the dollar. The pound advanced by 4%, while the French franc rose by 3% vis-a-vis the dollar. The Canadian dollar held steady. Largely on the basis of weakness in July, the dollar continued to depreciate over the third quarter with the exception of a 6% gain on the pound.

Preliminary data indicate that the market's sharp plunge of over 60 points in early July did not scare off foreign investors. In fact, it appears foreign net purchases escalated from June's low level. Our preliminary and confidential data indicate that foreign investors were net purchasers of about $1.5 billion of U.S. equities in July and also in August.

Foreign Activity in U.S. Equities

Gross Activity

Starting with the fourth quarter of 1985, foreign purchases and sales of U.S. equities set three consecutive quarterly records. An impressive $49.0 billion was reached in the last quarter of 1985, $59.3 billion in the first quarter of 1986, and $72.1 billion in the second quarter of the year. Continued 20% quarterly gains would put fourth-quarter gross activity at over $100 billion. Nevertheless, the $131.4 billion in foreign gross transactions at the half year mark already represents 83% of 1985's annual high of $159.0 billion.

Each major region accelerated gross activity in U.S. equities for an overall increase of 22% in the second quarter from the first quarter level. Latin American and Caribbean investors boosted gross activity by 40% to $10.7 billion, Canadian investors by almost 30%, and Asian investors increased transactions by 24%. Although every major European country stepped up activity, the 15% pace fell short of the 28% increase in the first quarter. European gross activity in U.S. equities rose to $38.5 billion in the second quarter from $33.5 billion in the first.

Net Purchases

Similar to gross activity, foreign net purchases of U.S. equities has reached three consecutive quarterly highs. Fourth-quarter 1985 enthusiasm pushed net purchases to a record $4.1 billion, which was subsequently shattered by an over 50% increase to $6.4 billion in the first quarter of 1986. In the second quarter, foreign net purchases increased a comparably modest 10% to set a new quarterly record of $7.0 billion. Thus, foreign net purchases of U.S. equities in the first six months of 1986 totaled a significant $13.4 billion. In comparison, net purchases of $5.8 billion represent the annual high set in 1981.

A note of caution, however, should enter projections of annual net activity. Foreign net purchases reached a monthly high of $3.9 billion in April and dropped to a still-substantial $2.8 billion in May. In stark contrast, foreign interest in U.S. equities plummeted to only $344 million in June. While June's figure is preliminary and extremely low, it may indicate that the record pace of foreign acquisition of U.S. equities may be subsiding. Preliminary data for later months support this trend.

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1986 First Quarter		1986 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$33,494	$4,770	$38,455	$3,819
Belgium-Luxembourg	1,549	135	2,375	275
France	2,036	(156)	2,908	358
Germany	2,711	598	2,779	(25)
Netherlands	1,458	396	1,854	455
Switzerland	9,618	1,406	10,275	807
United Kingdom	14,861	2,269	16,316	1,329
Canada	7,469	139	9,658	223
Latin America & Caribbean	7,632	344	10,717	1,405
Bermuda	2,178	4	3,092	357
Netherlands Antilles	2,312	175	2,990	217
Asia	9,254	860	11,480	1,305
Hong Kong	1,431	41	1,909	91
Japan	3,402	348	4,105	849
"Other Asia"*	3,765	316	4,800	220
Total All Countries	$59,271	$6,361	$72,117	$7,027

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

There are notable shifts in investment patterns in the second quarter. A significant increase in net purchases, to over $1 billion, by Latin American, Caribbean, and Asian investors accounted for maintaining a record level of foreign activity in U.S. equities. Exchange rates may have been a factor which encouraged net purchases from Latin American and Caribbean investors. Net purchases by these countries offset the 20% cutback by European investors. Latin American, Caribbean, and Asian investors were responsible for 39% of total foreign net purchases in the second quarter, compared with 19% in the first quarter.

European Investors

European investors scaled back net purchases of U.S. equities by 20% to $3.8 billion in the second quarter from $4.8 billion in the first. Reductions in net purchases of over 40% were made by Swiss and U.K. investors. The turnaround by German investors to net sellers of $25 million from net purchasers of $598 million also contributed to the dampened level of European net activity. Offsetting the diminished interest of these countries were upscaled net purchases stemming from the Netherlands and Belgium-Luxembourg countries and the swing of French investors to net purchasers of $358 million from net sellers of $156 million in the first quarter.

U.K. investors slashed net purchases to $1.3 billion in the second quarter from $2.3 billion in the first. Given that first-quarter net purchases evidenced an exceptional enthusiasm even for these traditionally major European buyers of U.S. equities, second-quarter activity would seem more the norm. During the quarter, the pound continued to advance on the dollar and the U.K. stock market stalled. U.K. investors may have concentrated on rising returns on domestic fixed-income instruments, as British authorities maintained comparably high interest rates to steady the pound.

Similar to U.K. investors, Swiss investors reduced net purchases by 43% to $807 million in the second quarter from $1.4 billion in the first. Swiss investors turned to U.S. equities early in the year as the notable 1985 performance of the Swiss stock market did not carry over into 1986. The Swiss market's first-half 1986 performance cumulated in a 3% loss. While this loss is modest, the economic outlook for the export-oriented Swiss economy could be undermined by the strong franc. Nevertheless, given the slowing climb of the U.S. stock market and the franc's stride of over 9% in the second quarter, Swiss investors may have been focusing on diminishing prospects for stock market appreciation offsetting currency depreciation.

French investors have kept their distance from U.S. equities in recent quarters. The first quarter of 1986 saw a sharp 34% run-up in the French stock market, which had enjoyed a booming revival in 1985. In the second quarter, however, the French stock market's climb came to an abrupt halt. Heightened price-earning ratios and a flood of new issues--as much new equity capital was raised in the first four months of 1986 as in all of 1985--may have prompted investors to seek other markets.1/ With easier foreign exchange controls, French

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1/ "Still finding its feet", The Economist, 6/14/86

investors turned to the still-rallying U.S. market. Net purchases of $358 million were made in the second quarter, in contrast to net sales of $156 million in the first.

German investors were the only Europeans making net sales of U.S. equities, $25 million, in the second quarter. However, net activity in the two previous quarters resulted in purchases of $1.4 billion, a somewhat high level for these investors. As the second quarter progressed, much attention focused on the German mark as speculation on German interest rate cuts to stimulate economic growth intensified. But, after suffering a setback in the first quarter, the German economy appears to be set for strong growth in 1986 and the authorities appear reluctant to cut interest rates. With economic growth estimated in the 5-6% range and uncertainty over interest rates, German investors were on the sidelines when it came to U.S. equities in the second quarter.

Canadian Investors

Canadian investors have shown little of the exuberance for U.S. equities that other foreign investors have shown in recent quarters. Although second-quarter net purchases jumped 60% to $223 million from $139 million, this level of activity is low in comparison. The adjustment of Canada's oil-producing provinces to lower oil-prices has put a drag on Canada's economic growth. In addition, a weak Canadian dollar has been steadied by high interest rates. Both these factors have dampened stock market progress. The downtrend of Canadian interest rates over the second quarter may have encouraged a swing from domestic fixed-income instruments to U.S. equities, given a stagnating domestic stock market.

Latin American & Caribbean Investors

In the second quarter, net purchases by Latin American and Caribbean investors rose to $1.4 billion, over 4 times the first-quarter level of $344 million. In 1986 there has been sporadic pick-ups in net activity from certain off-shore centers and other countries not shown in Table I. For example, in the second quarter, net purchases of almost $400 million of U.S. equities stemmed from the Bahamas. The relative stability of the U.S. economy coupled with the "safe haven" status remains a key attraction for investmen inflows from this region.

Asian Investors

Asian investors stepped up net purchases of U.S. equities by 52% to $1.3 billion from $860 million in the first quarter. Upscaled interest in U.S. equities by Japanese investors accounted for the increase. These investors boosted net purchases to $849 million from $348 million. The noted trend

of Japanese investment in equities in recent quarters is consistent with reports that Japanese investors are diversifying their U.S. portfolios, which consist largely of fixed-income instruments.

Foreign Activity in U.S. Corporate Bonds

Foreign net purchases of U.S. corporate bonds increased 11% in the second quarter to $12.6 billion from $11.4 billion in the first quarter. The moderate increase in net purchases of corporate bonds parallels a moderate uptrend in yields over the quarter. Corporate bond yields ended March at 8.63%, rose to 9.00% in April, and to a quarterly peak of 9.20% in May. Yields settled back in June to the April level of 9.00%.2/ Foreign net purchases of corporate bonds followed this path, reaching an unusually strong $6.2 billion in May.

TABLE II

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS
($ Millions)

	1986 First Quarter		1986 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$24,195	$9,377	$31,921	$12,035
Belgium-Luxembourg	258	(14)	472	(158)
France	498	3	404	61
Germany	4,409	(27)	2,370	314
Switzerland	2,106	1,310	2,858	2,126
United Kingdom	18,329	7,965	25,341	9,639
Asia	5,275	2,193	5,229	69
Japan	3,544	1,886	2,308	613
"Other Asia"	1,194	238	2,390	(693)
Total All Countries	$32,154	$11.390	$39,213	$12,612

Source: U.S. Treasury

2/ Based on data in World Financial Markets, Morgan Guaranty Trust Company.

As U.K. and Swiss investors reduced their net purchases of U.S. equities in the second quarter, they stepped up net purchases of U.S. corporate bonds. U.K. investors increased net purchases by 21% to $9.6 billion, while Swiss investors increased net purchases by 62% to $2.1 billion. The swing in investment preferences by these two groups of investors pushed net purchases by the European region to $12.0 billion in the second quarter, an increase of 28% from the first-quarter level of $9.4 billion.

A change in U.S. investment preferences can also be seen in the activity of Japanese investors. Net purchases from the Asian region plunged to $69 million in the second quarter from $2.2 billion in the first as Japanese investors swung to Treasuries for U.S. fixed-income investment. Japanese investors made net purchases of $613 million of corporate bonds in the second quarter compared to $1.9 billion in the first. Following a similar pattern, investors from the oil-exporting countries were net sellers of $693 million of corporate bonds in the second quarter but net purchasers of $1.0 billion of Treasuries, a level not seen for some time.

Foreign Activity in U.S. Treasury Notes & Bonds

Foreign net purchases of U.S. Treasuries increased 8% in the second quarter to $9.1 billion from $8.5 billion. Second-quarter activity brings foreign holdings of Treasuries to an estimated $157.9 billion. In contrast to the first quarter, when only $300 million of net purchases of Treasuries represented foreign official institutions' activity, $5.7 billion or 62% of foreign Treasury purchases were made by these institutions in the second quarter. Activity by private foreigners and financial institutions had previously dominated foreign activity in Treasuries. These investors acquired over $20.0 billion U.S. Treasuries in 1985, while foreign official institutions purchased $8.1 billion.

In the second quarter, the Asian region significantly increased net purchases of Treasuries. From only $221 million in net accumulation in the first quarter, Treasury buying by this region jumped to $3.7 billion. Investors in both Japan and the oil-exporting countries made net purchases of over $1 billion of Treasuries. In part, Japanese activity could reflect official intervention to counter upward pressure on the yen. Net purchases of $735 million from investors located in Korea and of over $400 million each from Hong Kong and Singapore investors also contributed to the high second-quarter level (not shown in Table III).

TABLE III

NET FOREIGN PURCHASES AND TOTAL FOREIGN HOLDINGS
OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1986 First Quarter		1986 Second Quarter	
	Net Purchases	Estimated Holdings	Net Purchases	Estimated Holdings
Europe	$3,739	$ 54,180	$5,448	$ 59,628
Switzerland	205	2,739	877	3,616
West Germany	913	23,049	964	24,013
United Kingdom	2,801	14,318	1,,032	15,350
Asia	221	69,517	3,724	73,241
Japan	880	39,939	1,058	40,997
"Other Asia"*	(686)	20,878	1,030	21,908
Nonmonetary Int'l & Regional Org.	3,204	13,804	(780)	13,024
All Countries	$8,500	$148,733	$9,141	$157,874

Source: U.S. Treasury

* Treasury has discontinued publication of the estimated holdings of the oil-exporting countries. Figures based on last published figure plus summation of quarterly data.

While second-quarter Japanese net purchases of Treasuries rose 20% from the first-quarter level, Japanese interest is strikingly lower than last year. In 1985, Japanese investors bought almost $19 billion of U.S. Treasuries. The continued rise of the yen against the dollar, a narrowing of differentials, and Japanese efforts to offer more attractive investment vehicles may have diminished the attractiveness of Treasuries. It is projected that the growth of Japanese investment in foreign securities has slowed, and will drop to 15% in 1986 from 1985's growth rate of 80%.3/

3/ "The Japan Sea Bubble?" The Economist, 8/30/86

European net purchases rose 46% to $5.4 billion in the second quarter from $3.7 in the first. The increase in activity stemmed from those countries generally not major players in the Treasury market. Transactions originating from Norway and Sweden accounted for $740 million and $365 million, respectively, of net purchases (not shown in Table III). Of the major players, the U.K. reduced net purchases of Treasuries by 63% to $1.0 billion. On the other hand, net purchases from Germany were increased modestly to $964 million, while Swiss purchases leaped to $877 million.

U.S. Investor Activity in Foreign Stocks

Although there were dramatic shifts in investment patterns, U.S. investor interest in foreign stocks was maintained at the first-quarter record level of $2.1 billion in the second quarter. This puts U.S. net purchases of foreign stocks at $4.2 billion at the half year mark, compared to 1985's annual record of $3.9 billion. Similarly, with a 25% jump to $25.3 billion, U.S. transactions in foreign stocks in the first six months of 1986 are a match with 1985's annual activity, about $45.5 billion. Clearly, international flows in equities are now a two-way street.

The U.S. level of investment in Japanese securities in the second quarter seems unrealistic after the bullish sentiment of the first quarter. Second-quarter activity resulted in net purchases of only $198 million compared with exceptionally large net purchases of $1.1 billion in the first quarter. In the second quarter, the Japanese stock market performed moderately better than the U.S. market and the yen continued to appreciate vis-a-vis the dollar. The strength of the yen may be one factor prompting U.S. investors to adopt a cautious position on Japanese stocks. A strong yen reduces export growth and profits for Japan's blue-chip sector, the traditional sector preferred by foreign investors.

U.S. investor interest focused on European investment in the second quarter. Net purchases of European stocks were boosted from $556 million to $1.3 billion. Interest in the stocks of most major European countries picked up, with a sharp acceleration in net purchases of U.K. stocks and a swing to net purchasers of stocks of Netherlands companies. U.S. purchases of U.K. stocks were increased to $746 million from $360 million in the first quarter. The U.K. stock market experienced the same slowdown as other major markets in the second quarter, and U.K. interest rates remained high to protect the pound. U.S. investors may have been purchasing gold mining shares and/or selectively buying U.K. stocks which represent those sectors that will benefit in the long run from declining oil prices.

TABLE IV

GROSS ACTIVITY IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1986 First Quarter		1986 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$11,326	$556	$12,702	$1,320
France	757	199	875	241
Germany	1,489	125	1,619	203
Netherlands	889	(281)	1,020	56
Switzerland	677	43	780	18
United Kingdom	6,808	360	7,430	746
Canada	2,444	536	3,326	330
Asia	5,302	1,302	7,591	123
Japan	4,531	1,097	6,660	198
Other	1,138	(306)	1,676	364
All Countries	$20,210	$2,088	$25,295	$2,137

Source: U.S. Treasury

In addition, despite setbacks in the stock markets of both countries, U.S. investors increased net purchases of stocks of French and German companies. Net purchases of $241 million of French stocks were made and of $203 million of German stocks. U.S. investors may have been focusing on currency appreciation and relatively favorable economic outlooks for these countries.

U.S. investors reduced net purchases of Canadian stocks by 38% in the second quarter. Net purchases dropped to $330 million from $536 million in the first quarter. Economic prospects for the Canadian economy dimmed somewhat in the second quarter, as first-quarter growth failed to keep pace with 1985's 4.5%. High interest rates, a weak Canadian dollar, and the slide of the Canadian stock market in the second quarter may have prompted the cutback by U.S. investors.

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